Potential Executive Actions to Close Tax Loopholes

Several problems with our tax code could be addressed through executive action to start the process of tax reform. Current tax laws authorize the Administration to issue regulations that would likely address several of the most egregious loopholes.

I. Summary

Check-the-Box Loophole
Ten-year revenue impact: Up to $78 billion
This loophole allows multinational companies to characterize their offshore subsidiaries in different ways to different governments so that their profits are ultimately taxed by no government at all. Senators Carl Levin and John McCain issued a hearing report explaining that Apple used this loophole and recommending that Congress close it.

Carried Interest Loophole
Ten-year revenue impact: $18 billion
The carried interest loophole allows Wall Street hedge fund managers to characterize their compensation (which they earn for managing other people's money) as capital gains, which is taxed at a lower rates than other types of income.

Corporate Inversions
Ten-year revenue impact: Up to $13 billion
A corporate inversion takes place when a corporation merges with a (usually much smaller) foreign company and then reincorporates as a foreign company to avoid U.S. taxes even as it continues to operate and be managed in the U.S.

Valuation Discounts that Reduce Estate and Gift Taxes
Ten-year revenue impact: $18 billion
Gifts and bequests of ownership rights in family businesses sometimes includes formal restrictions on what the recipient can do (for example, preventing a business from being sold outside the family) that are actually meaningless but which are claimed to dramatically reduce the value for estate tax or gift tax purposes.

Corporate Offshore Tax Avoidance Using Short Term Loans
Ten-year revenue impact: unknown
American corporations are supposed to pay U.S. taxes on their offshore profits when those profits are brought to the U.S., but companies like Hewlett-Packard have avoided this by having offshore profits circulated to the U.S. by a continuous series of short term "loans" from subsidiaries in tax havens like the Cayman Islands.

Real Estate Investment Trust Loophole
Ten-year revenue impact: unknown
IRS administrative rulings have created a loophole allowing private prisons, billboard

companies, casinos and other businesses to claim that they are making money from rents and structure themselves as real estate investment trusts (REITs) which do not pay the corporate income tax.

II. Details

Corporate Offshore Tax Avoidance Using Check-the-Box Rules
Ten-year revenue impact: unknown, possibly up to $78 billion

The "check-the-box" rules were adopted through regulations in 1997 and allow a company to decide (by literally checking a box on a form) whether or not to characterize an entity it owns as a separate corporation. The Clinton Administration quickly realized that this created a significant problem in the international context because multinational companies can characterize their offshore subsidiaries in different ways to different governments (such subsidiaries are often called "hybrid entities") so that their profits are ultimately taxed by no government at all.

In 2013, Senator Carl Levin held a hearing of the Homeland Security and Government Affairs Permanent Subcommittee on Investigations on Apple's use of offshore tax havens. Senator Levin and the subcommittee's ranking member John McCain issued a report explaining that Apple used this loophole and recommended that Congress close it.

Businesses are generally allowed to deduct expenses like interest paid on debt from their gross income when calculating taxable income. Without rules to prevent abuse, some corporations would arrange financial transactions in which they make large interest payments to their offshore subsidiaries and use the deductions to wipe out their income for U.S. tax purposes. Our tax rules generally try to prevent this by taxing interest (and certain other types of income) when it is earned by of offshore subsidiaries of American corporations.

But corporations can circumvent these anti-abuse provisions by using check-the-box rules. For example, a subsidiary of an American company in Germany could make an interest payment to another subsidiary in a tax haven country, and tell the German government it is entitled to a deduction because it made an interest payment to another corporation. But then it tells the American government that the tax haven company is just a *branch* of the German company so the payment was an internal company payment, meaning there is no profit to tax. In reality, that payment is a profit that is not taxed anywhere.

The Clinton Administration proposed rules to address the problem — which were withdrawn after Congress threatened to legislatively lock the check-the-box rules in place.

This problem demands particular attention because the OECD, through its Base Erosion and Profit Shifting (BEPS) project which the U.S. has been heavily involved in, has called on countries to end the tax avoidance associated with hybrid entities created through check-the-box. If Congress refuses to act, the Administration arguably must act alone to implement the OECD's recommendations and cooperate with the BEPS project.

President Obama proposed in his fiscal year 2010 budget to address the international tax avoidance associated with check-the-box through legislation. JCT estimated that the President's proposal, which included several complex exceptions, would raise $31 billion over a decade. A simpler version of this proposal from Senator Levin was said to raise $78 billion over a decade. This presumably means that $78 billion is the outer limit on the possible revenue savings from addressing this problem through executive action.

Carried Interest Loophole
Ten-year revenue impact: $18 billion

The carried interest loophole allows wealthy buyout fund managers to characterize their compensation (which they earn for managing other people's money) as capital gains, which is taxed at a lower rates than other types of income. The top personal income tax rate for capital gains is just 20 percent, about half the top rate of 39.6 percent that applies to other types of income.

The general idea behind the lower rate for capital gains is that people who invest money should pay a lower rate on the return from that investment. This idea has never made much sense, but it is even worse when a loophole like this one is used to obtain the lower tax rate for income that is *not* a return on investment but is actually compensation paid for work (for the services provided by fund managers). Income in the form of carried interest can run into the hundreds of millions (or even in excess of a billion dollars) a year for individual fund managers, raising the question of why this particular group needs a special tax break.

Victor Fleischer, a tax law professor at the University of San Diego who first drew Washington's attention to the carried interest loophole, has written that the Administration has the authority under existing law to close this loophole. He points out that section 707(a)(2)(A) of the tax code authorizes the Treasury Department to issue regulations addressing the extent to which partners in a business are paid for compensation or paid returns on investments they have made — and Treasury has not done so in the 30 years this has been on the books. Treasury can simply define fund managers as service providers so that carried interest is taxed as earned income.

Corporate Inversions
Ten-year revenue impact: Up to $13 billion

A corporate inversion takes place when a corporation merges with a (usually much smaller) foreign company and then reincorporates as a foreign company to avoid U.S. taxes even as it continues to operate and be managed in the U.S.

Congress needs to close the loophole allowing these corporations to claim that they are foreign companies for tax purposes. Until Congress acts, regulatory action can help by tightening the rules and blocking some of the tax dodges that are available to inverted companies. This would eliminate much of the motivation for corporate inversions.

In July of 2014, former Treasury official and Harvard Law scholar Stephen Shay published an article arguing that the Administration could act to block the two main tax dodges that become available to corporations after they invert. The first involves "hopscotch" loans, which inverted corporations could use to effectively shift offshore profits back into the U.S. without paying taxes on them. The second major tax dodge available to inverted corporations is "earnings stripping." In September of last year, the Treasury department issued a notice effectively addressing the first tax dodge (hopscotch loans) but only hinted that it would eventually address the second tax dodge (earnings stripping).

Corporations claiming to be based abroad (and corporations that really are based abroad) are able to use earnings stripping techniques to make profits earned in the U.S. appear to be earned in countries where they will be taxed more lightly or not at all. Earnings are stripped out of the U.S. when a foreign-owned U.S. corporation (which an inverted company technically is) borrows money from its foreign parent corporation, to which it makes large interest payments that wipe out U.S. income for tax purposes. The loan is really an accounting gimmick, since all the related corporations involved are really one company that is simply shifting money from one part to the other. The interest payments made by the American corporation in effect shift the profits that are really earned in the U.S. to the foreign country for tax purposes.

Shay's article explained that the Treasury Department could issue regulations under section 385 of the tax code that would limit earnings stripping for inverted corporations. That section of the law essentially allows Treasury to issue regulations to determine whether an interest in a corporation is treated as debt or equity (stock). Regulations could, Shay explains, reclassify excessive debt taken on by an inverted American company from its (ostensible) foreign parent company as equity. This would mean that any interest payments made by the inverted American corporation would be reclassified as dividends paid on stock, which, unlike interest payments made on debt, are not deductible. Shay proposes specific calculations for Treasury to use, but there probably are several ways that it could define excess indebtedness that would be reclassified as equity.

Valuation Discounts that Reduce Estate and Gift Taxes
Ten-year revenue impact: $18 billion

Wealthy people sometimes transfer to their children a small part of a family-owned business with restrictions on the children's ability to sell or control that business. Even though these "restrictions" are often ignored or removed later, families claim that they reduce the value of the gift for purposes of calculating the gift or estate tax. In his first four budget plans, President Obama included a proposal that would essentially have the IRS ignore some of the meaningless "restrictions" in these transfers, which will result in a higher value for gift and estate tax purposes. The Treasury Department has estimated that these proposals would raise $18 billion over a decade.

In its analysis of the President's proposals in 2009, JCT commented that it seemed that Treasury was about to issue regulations addressing this issue and suggested that legislation was not even necessary.

> "Some also may argue that, even in the absence of the proposal, the Secretary has broad authority under section 2704(b)(4) to issue new regulations establishing restrictions that must be disregarded in valuing transfers of an interest in a family-controlled entity… Furthermore, the IRS and Treasury business plan for 2008-2009 describes a plan to issue guidance under § 2704 regarding restrictions on the liquidation of an interest in a

> corporation or partnership. The Treasury Department's explicit plan to issue new guidance under section 2704(b) arguably raises questions about whether a legislative modification of this section is premature or even necessary."

It is quite possible that when Treasury was considering addressing the issue through regulations, the Administration changed course and proposed the measure as a legislative change that could be used as a revenue-raising provision to offset the cost of other measures. But given that that the majority in the House and Senate now support outright repeal of the estate tax, it is highly unlikely that this Congress would act to close loopholes in the estate tax.

Corporate Offshore Tax Avoidance Using Short Term Loans
Ten-year revenue impact: unknown

American corporations are supposed to pay U.S. income taxes on their offshore profits when those profits are brought to the U.S. In 2012, Senator Carl Levin held a hearing of the Homeland Security and Government Affairs Permanent Subcommittee on Investigations revealing that Hewlett-Packard had found a way around this rule. HP had its offshore subsidiaries provide a continuous series of short term loans that effectively transferred offshore profits into the U.S. without triggering U.S. income tax that would normally apply when offshore corporate profits are repatriated.

Section 956 of the tax code is designed to prevent this. Section 956 treats such loans from offshore subsidiaries to their American parent corporations as a "deemed repatriation" that would be subject to U.S. taxes. The problem is that Treasury regulations created exceptions to these rules that greatly weaken them.

Those regulations essentially say that section 956 does not apply if loans from offshore subsidiaries are outstanding for less than 30 days each and the total loans for the year are outstanding for less than 60 days. The Permanent Subcommittee on Investigations explained that Treasury then turned this exception into a bigger loophole by declaring that it would not count any loan that was not outstanding at the end of a quarter and that these limits apply separately to each subsidiary of a corporation.

As a result, HP was "borrowing" billions from several offshore subsidiaries, mainly one in the Cayman Islands and another in Belgium, using this money to fund its U.S. operations while officially holding less than a billion in the U.S.

Stephen Shay, the same international tax law scholar whose article on corporate inversions prompted the Treasury Department to act on that issue, testified before the subcommittee that Treasury has additional powers under existing law, under both section 956 and section 7701(l) to prevent this type of tax avoidance.

This seems straightforward. Section 956(e) says the "Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise." Section 7701(l) provides that "The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title."

Real Estate Investment Trust Loophole
Ten-year revenue impact: unknown

IRS administrative rulings have created a loophole allowing private prisons, billboard companies, casinos and other businesses to claim that they are making money from rents and thus structure themselves as real estate investment trusts (REITs), which do not pay the corporate income tax. REITs were created in 1960 to allow a way to invest in a diverse portfolio of real estate similar to investment in other types of business through mutual funds. The profits, most of which must be paid out to investors, are subject to personal income taxes but not corporate income taxes.

The problem is that companies engaging in all types of activities claim to earn profits from their real estate in order to conduct the business through REITs and avoid the corporate income tax. The New York Times has reported that these companies now include "Corrections Corporation of America, which owns and operates 44 prisons and detention centers across the nation," and "Penn National Gaming, which operates 22 casinos, including the M Resort Spa Casino in Las Vegas." They also include "Lamar Advertising, an outdoor advertising firm, and Equinix, a data center operator."

IRS administrative rulings basically allow these businesses to claim that their income is generated by the land and buildings that they are using and therefore qualify as REITs. Under this standard, it is not clear what would stop a fast food restaurant chain, a major chain retailer or any company with real estate assets from claiming that it can convert to a REIT in the same way and avoid the corporate income tax. The Treasury Department should issue regulations that undo the effect of these administrative rulings.